"Hooked On QE"

Market Commentary – December 2013

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.8% in the third quarter of 2013. This is higher than 2.5% in the second quarter. Looking around the globe at GDP readings reported by *The Economist*, growth in 2013 has been hard to come by. China is the exception with +7.8% GDP growth in 2013. Other major economies are not so fortunate: Japan +2.7%, Britain +1.5%, and Canada +1.4%. The Euro area is still struggling, with its economy contracting by -0.4%. The emerging markets of Eastern Europe are in the 1% to 2% range, while those in Asia are around 3% to 5%. If there is a benefit of muted growth, inflation worldwide generally seems to be under control (1% to 2%, aside from Russia at 6%, Egypt at 9%, India at 10%, and Venezuela at 39%).

The stock market is as addicted as ever to quantitative easing (QE), and it appears to have an ally in Janet Yellen, President Obama's nominee for chair of the Federal Reserve. In her testimony to the Senate Banking Committee in mid-November, Yellen said, "I believe that supporting the recovery today is the surest path to returning to a more normal approach to monetary policy." The S&P 500 jumped 0.8% that day and has rallied 2.6% since her comments. If she is officially confirmed as Federal Reserve Chairman when Ben Bernanke's term ends on January 31, 2014, Yellen is expected to continue the Fed's ultra-accommodative monetary policy. The Fed has kept interest rates near 0% since late 2008 and has expanded its balance sheet from around $900 billion in September 2008 to $3.9 trillion today. It continues to buy $85 billion in bonds each month (also known as "quantitative easing").

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $116.68, which implies a price-to-earnings (P/E) ratio of 15.5 with the S&P 500 at 1806. The earnings yield (E/P) of 6.46% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.74%. Earnings growth is not driving the rally in stock prices. Curiously, earnings estimates have been going down in recent months. S&P reports that earnings estimates for the S&P 500 in 2014 have been in a continuous decline since July 2013, falling from around $123 to $121. The 217 stocks in our universe confirm this finding, as estimates over the past 90 days are down for 127 stocks, while those for only 72 stocks are up.

The stock market has chugged higher and higher since the dip in early October. At some point, stock prices will need to rest. This is especially true since earnings growth is not driving stock prices. Stocks are rising due to P/E expansion. With quantitative easing in place and short-term interest rates staying low for many months to come, it is difficult for investors to "fight the Fed". Support levels on the S&P 500 exist around 1742 (50-day moving average), 1725 (September high), and 1650 (October low and 200-day moving average). Since the index is at an all-time high, there is no resistance above.

Some investors are feeling a need to chase stocks at higher prices; we take the opposite approach. In recent weeks, we have been building our portfolios' margins of safety by selling stocks that are more richly priced and with higher betas. We have also sold some covered calls with maturities ranging from December 2013 to April 2014. On the buying front, we have researched several new companies trading at attractive valuations, with healthy balance sheets and solid dividends. When there is some eventual market weakness, we anticipate putting more capital to work…incrementally. Our readers may want to take a look again at the final paragraph of our August 2013 market commentary. The "1987 scenario" appears more likely at some point in 2014, especially as stocks outpace earnings. Should a severe correction occur, we would buy into such fear. Our investment strategy, which is based on a "balanced" and "incremental" approach, helps us to be more logical during emotional times.